SB 305
"OIL AND GAS PRODUCTION TAX"
SECTIONAL ANALYSIS

Section 1: This section addresses the legislative intent of sec. 11 of the bill, which amends AS 43.55.020(f), a provision of the production tax statute. Section 1 explains that the intent is not to change the meaning or effect of that law but rather to confirm the meaning as it has long been interpreted by the Department of Revenue.

Sections 2 and 3: These sections amend provisions of the corporate income tax statute, AS 43.20, to ensure that the oil and gas production tax, as amended by this bill, is not treated the way an income tax is treated under that statute. Specifically, the amendments ensure that the production tax may be deducted, and that the production tax will not be added back to federal taxable income, for purposes of computing the corporate income tax.

Section 4: This section deals with criminal penalties for unauthorized disclosure of confidential tax records. Currently, AS 43.05.230(f) subjects current or former state officers, employees, and agents to fine or imprisonment for such disclosure. Section 4 would extend the criminal penalties to private persons who violate conditions imposed by the Department of Revenue limiting access to and use of certain confidential information related to the production tax.

Section 5: This section is one of the core provisions of the bill. It (together with the repealer provision, sec. 34) replaces the current production taxes on oil and gas with a single production tax on both oil and gas. The current taxes are generally based on a percentage of the *gross* value of oil or gas at the point of production As amended by sec. 5, the production tax is equal to 20 percent of the *net* value of oil and gas. Section 21 of the bill addresses how net value is determined.

Section 6: This section conforms certain existing statutory terminology to that used in the Internal Revenue Code and incorporates a definition that no longer needs to be located in a separate definitions section of the statute.

Section 7: This section deals with production tax payment due dates and interest. As under existing law, the production tax remains a monthly tax, but because a taxpayer's exact liability may be subject to adjustment in light of later information or events (such as capital investments), only 90 percent of the tax is initially due each month. The remainder is due when a "true-up" return is filed by March 31 of the next calendar year.

Sections 8, 18, 19, 22, 23, 26, 27, and 38: These sections are simply conforming amendments or updates to reflect current legislative language usage.

Section 9: This section deals with a producer's right to charge a private royalty owner for the share of production taxes attributable to royalty oil and gas. That right is recognized in existing law; what the section adds is a method of determining the royalty share of the taxes in the absence of an agreement between the producer and royalty owner to use a different method.

Section 10: This section expands the current production tax exemption for gas that is used in lease operations, to include oil that is used in lease operations. The section also simplifies the treatment of flared gas, which currently may be tax exempt, taxable, or both taxable and subject to a penalty, depending on why it is flared. Under this bill, gas whose flaring is authorized by the Alaska Oil and Gas Conservation Commission would be tax exempt; and otherwise it would be taxable.

Section 11: This section amends a provision of the production tax statute allowing the Department of Revenue to require production tax to be paid on the basis of the prevailing value of oil or gas. The section clarifies that the provision applies, not only where the sale price of oil or gas is sold differs from the prevailing value, but also where the oil or gas is not sold at all – for example, where it is refined by the company that produced it.

Section 12: This core section of the bill provides for two new types of tax credits that may be applied against the production tax. One is in the amount of 20 percent of capital expenditures for oil or gas exploration, development, or production. The other is in the amount of 20 percent of net losses from oil or gas exploration, development, or production that are carried forward from previous years. An unused credit may be sold to other producers by applying to the Department of Revenue for a transferable tax credit certificate. If the Department of Revenue later finds that the original producer's credit claim was invalid, it may assess a tax deficiency against that producer, but the purchaser of the certificate would still be able to rely on and use the certificate in full.

Sections 13 - 15: These sections update the statutory provisions that govern production tax returns, including requiring those returns to report on the costs that will be deductible under this bill for purposes of calculating taxable net value of oil and gas. The annual return that "trues up" prior year monthly returns must show any adjustments or corrections to those monthly returns. Section 13 repeals a $25 per day penalty for failure to file a production tax return, in light of the fact that there is a generally applicable late-filing penalty in the tax administration provisions of AS 43.

Section 16: This section clarifies that the Department of Revenue's power to obtain information relevant to determining taxes includes the power to require the filing of regular reports. The section also clarifies the statutory confidentiality restrictions on tax information, recognizing that the Department of Revenue may disclose such information to a taxpayer when it is necessary to compute that taxpayer's liability. In such circumstances, the Department is required to impose appropriate limitations on which individuals may have access to the information and how the information may be used.

Section 17: This section amends the current requirement that production taxes be deposited in the general fund, to incorporate exceptions imposed under the constitutional budget reserve fund amendment.

Section 20: This section amends AS 43.55.150, which deals with determining the gross value at the point of production of oil and gas. The section authorizes the Department of Revenue to allow producers to calculate the gross value with a formula that uses a producer's royalty settlement agreement with the state, or a royalty value or valuation methodology accepted by the Department of Natural Resources or the United States Department of the Interior in certain cases, or another formula using such factors as published price indices.

Section 21: This section, a core provision of the bill, provides for the calculation of a producer's net value of taxable oil and gas. This calculation may include five steps. First, the gross value at the point of production of all of the producer's taxable oil and gas statewide is computed. Second, the producer's deductible costs of oil and gas exploration, development, and production – called adjusted lease expenditures -- in the state are totaled. Third, those costs are deducted from gross value. Fourth, a specified fraction of the producer's oil and gas capital investments during the five years before the new tax law takes effect may be deducted. Fifth, an allowance of up to $73 million, spread over a calendar year, may be deducted. In no case, however, may the net value calculation for oil and gas drop below zero; the section establishes rules for the treatment of unused deductions.

The section directs the Department of Revenue to give substantial weight, in determining deductible costs, to typical industry practices and standards as reflected in billable types of costs under joint operating agreements, and allows the Department of Revenue to authorize producers in appropriate circumstances to rely on billings under such agreements for production tax purposes. The section also provides examples of costs that are potentially deductible as "direct" costs and examples of costs that are not deductible because they are not "direct." Costs are required to be adjusted to account for reimbursements, asset sales, and other relevant producer receipts.

The section establishes limits on the deduction of previous capital investments, including a requirement that the West Coast price of Alaska North Slope oil must exceed $40 per barrel for the month. This figure is subject to future adjustment for inflation.

To benefit from an annual allowance of up to $73 million, a producer must qualify with the Department of Revenue. The qualification requirement is designed to prevent the proliferation of producer entities for tax avoidance purposes.

Sections 24 and 28: These sections provide that oil that is exempt from production tax because it is used in lease operations, is also exempt from the oil conservation surcharges under AS 43.55.

Sections 25 and 29: These sections allow a producer to take a credit against the production tax for the amount paid in oil conservation surcharges.

Sections 30 – 33: These sections change the existing statutory definitions of "oil," "gas," and "gross value at the point of production," and add new definitions for "gas processing" and "gas treatment." Under these definitions, gas processing is considered an operation upstream of the point of production for gas, and generally the line between what is oil and what is gas corresponds to what substances are in liquid form and what substances are in gaseous form, respectively, at the point of production.

Section 34: This section repeals provisions of the current oil and gas production taxes that will be obsolete under the new production tax. It also repeals definitions that will no longer be needed.

Sections 35 and 40: These sections specify that the new production tax provisions will take effect on July 1, 2006, and will apply to oil and gas produced on or after July 1, 2006. Section 11, the provision of the bill that confirms a long-standing agency interpretation of existing law, applies to oil and gas whenever produced.

Section 36: This section contains transition provisions that clarify how certain calendar year rules under the new production tax law will apply to the first half-year the law is in effect (i.e., the last six months of 2006). The section also provides that oil and gas produced before the new law takes effect will continue to be subject to the earlier production tax statute and regulations.

Section 37: This section contains another transition provision, authorizing the Department of Revenue to immediately develop and adopt implementing regulations so they can take effect at the time the new statutory provisions take effect.

Section 39: This section provides an immediate effective date for provisions of the bill that do not change the way the production tax is calculated, as well as the transition provision concerning regulations of the Department of Revenue.

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